DOW THEORY LETTERS INC.

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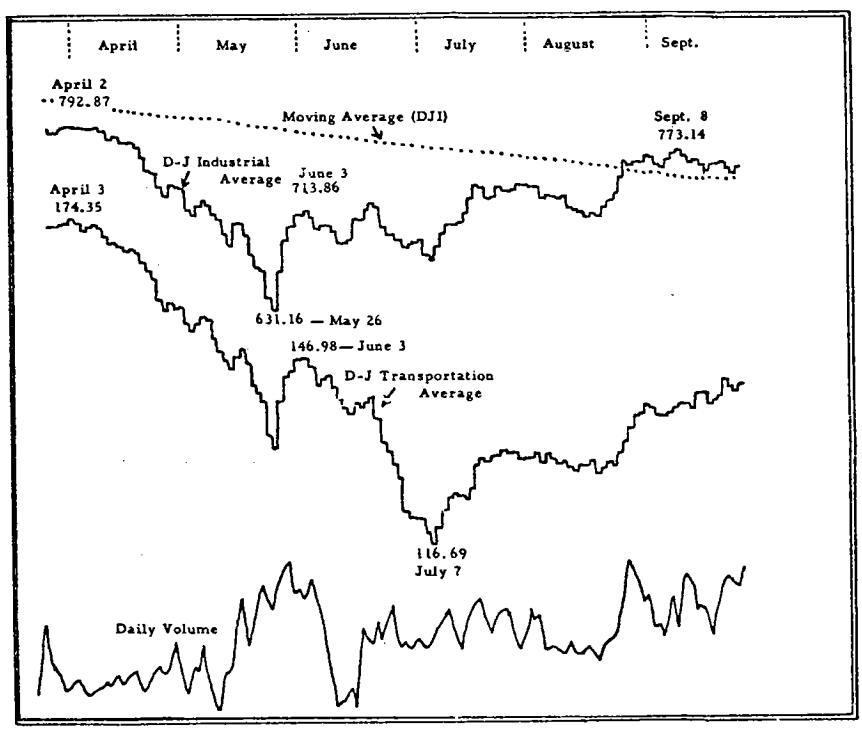
THE MARKET: The last Letter was rather "talky" and non-technical. This Letter is pretty much the opposite, and in it I am going to attempt to explain a formation in the Averages which should be understood by every market student. This may take a good bit of study and concentration on the part of readers, but I think it will be worth it, so here goes.

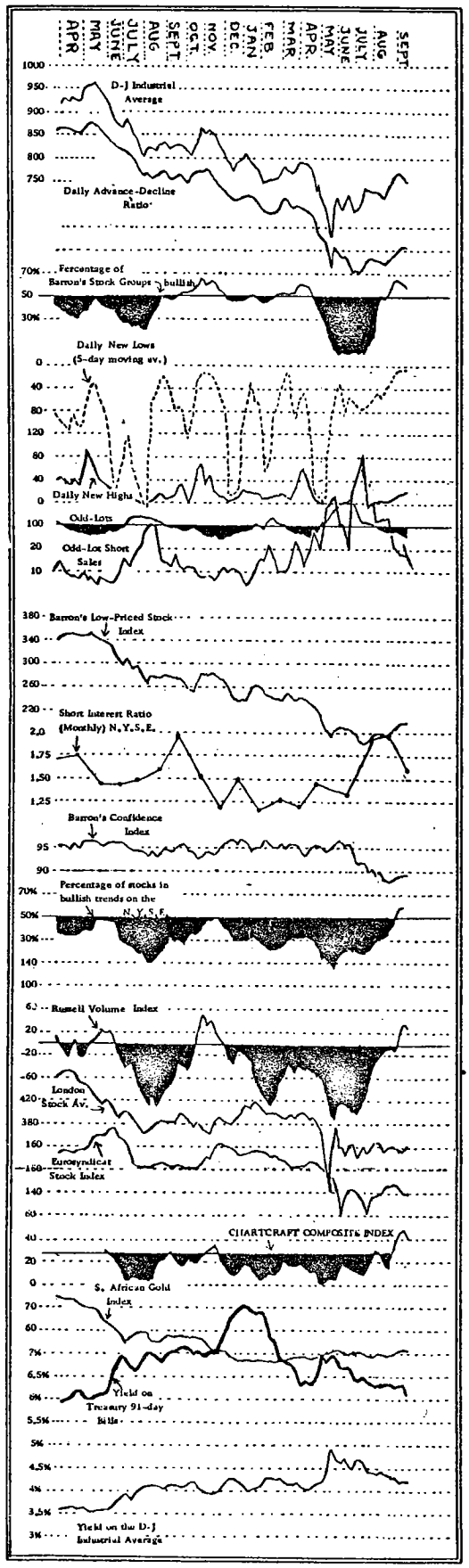
No one man can be credited with "producing" the Dow Theory. Charles H. Dow was certainly one of the great original minds in stock market and financial history. His wide-sweeping observations and conclusions form the groundwork of the Theory, yet Dow never presented his observations as the Dow Theory. In fact, it was after Dow's death that his friend, S. N. Nelson, first referred to Dow's observations as "Dow's Theory".

William P. Hamilton, Dow's understudy and later editor of the Wall Street Journal, was the first to actually present Dow's studies in the form of a workable theory of market movement. Hamilton's knowledge of finance and the stock market was almost legendary, and his book, "The Stock Market Barometer" forms the basis of the modern Dow Theory.

Robert Rhea, writing from his bed (following a plane accident) brought the Dow Theory to a fine edge. To my mind, Rhea was the greatest interpreter of the Averages. Writing between 1932 and 1939, Robert Rhea in his service provided a study of the price movement which for scholarship and brilliance has never been matched, much less surpassed.

My friend E. George Schaefer, writing from Indiana beginning in 1948, added certain technical considerations to the Dow Theory which I believe are pioneering in their importance. Schaefer seems to have a feel for the basic primary




D-J Industrial Average
Daily Advance-Decline Ratio
Percentage of Barron's Stock Groups bullish
Daily New Lows (5-day moving av.)
Daily New Highs
Odd-Lots
Odd-Lot Short Sales
Barron's Low-Priced Stock Index
Short Interest Ratio (Monthly) N.Y.S.E.
Barron's Confidence Index
Percentage of stocks in bullish trends on the N.Y.S.E.
Russell Volume Index
London Stock Av.
Eurosyndicat Stock Index
CHARTCRAFT COMPOSITE INDEX
S. African Gold Index
Yield on Treasury 91-day Bills
Yield on the D-J Industrial Average

 sweep of the market which is beyond anything which I have read or seen. I do not know what portion technical considerations, pure instinct or unconscious "feel" play in Schaefer's work, but he has yet to be wrong on the primary trend.

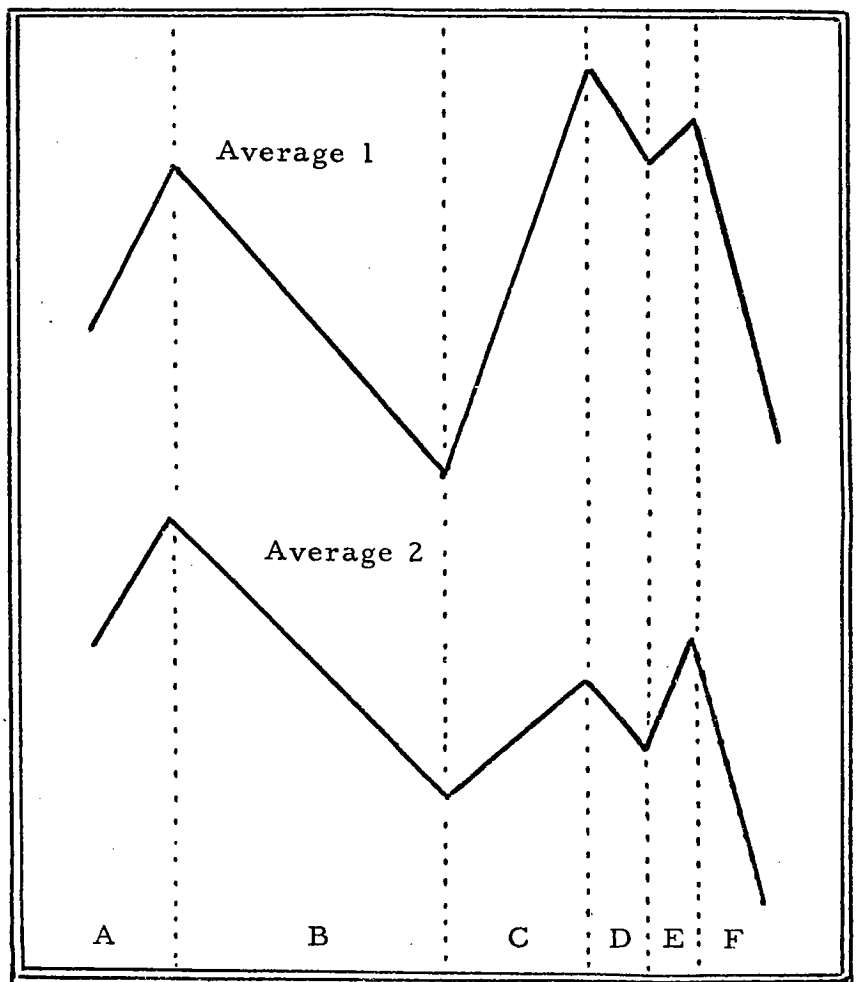
I have been studying the market since the 1940's, and I have tried to see and understand what is best in the works of the outstanding market analysts. From Dow and Hamilton I learned the basic Dow Theory as applied to the market and in conjunction with the economy. Dow and Hamilton give one a feel for the big picture in historical context which is second to none. From Rhea I learned how to read the Averages. From Schaefer I learned that there is a good deal more to the stock market than just reading the Averages.

At present I agree with Schaefer that the great primary tide of the market is down. Schaefer was the first to see that times have changed drastically on Wall Street since the 1930's and 1940's. He has often noted that with 20 to 30 million emotional investors in the market, with today's modern and instantaneous news communications, the market is much more under the sway of emotionalism than it was "in the old days". To put it briefly, 30 million investors can cause the market to do anything (false bull and bear signals, temporary panics, etc.) but always within the context of the overriding primary trend.

So here we are, in the midst of a (perhaps completed) secondary upward correction within a continuing primary bear market. The question is, what do we look for and at? As I see it, during a bear market one looks for and expects the market to move in the primary direction (which, of course, is down). When an upward correction is in progress, one attempts to gauge the power of the counter-primary forces, and one watches for the tell-tale hints of a reversal back to the primary direction.

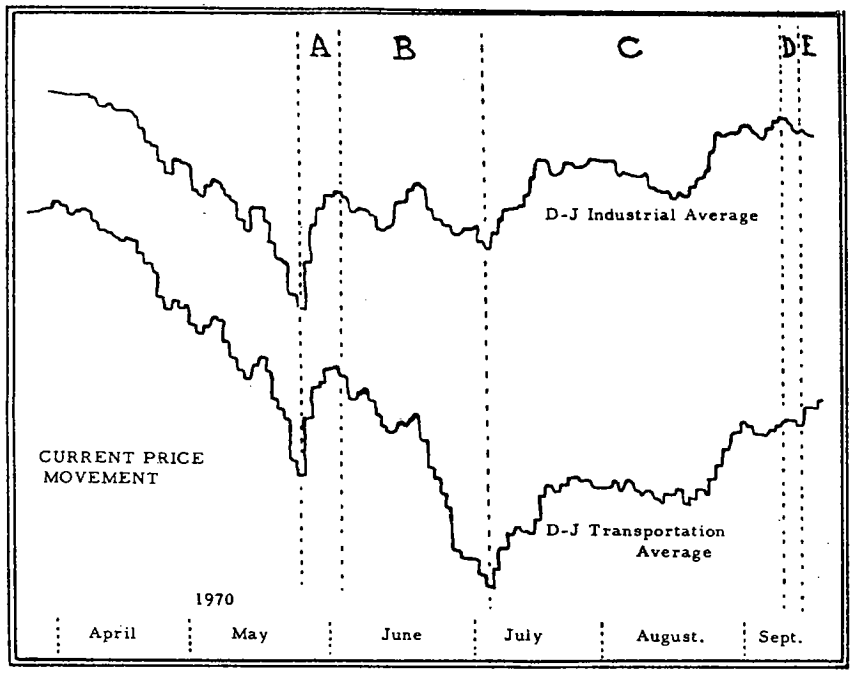
All of which takes me to this week's subject. One of the technical phenomenons which I have noticed but never seen in print is what I term the "double non-confirmation". I will try to explain. If both Averages (Industrials and Transports) rally to peaks, both decline, and then one Average goes to new highs (but not the other), this is a imple non-confirmation. If the stronger Average rallies to new high after high (but the other does not) I call this a series of non-confirmations. This is what has occurred since the June 3, 1970, peak in the two Averages. Looking at the page 1 chart you will see that Industrials closed at 713.86 while Transports closed at 146.98. Then a sharp decline carried into July. Since that time Industrials have executed a series of new recovery highs, but Transports have failed persistently to better their old June 3 peak of 146.98. This is what I term a series of non-confirmations.

This series of non-confirmations on the part of Transports carries an implication of weakness with it, particularly since the non-confirmations have occurred within a corrective rally which is against the primary trend. It is the Transports which failed to better the June 3 peak, and we must therefore say that the Industrials have been the stronger and the Transports the weaker Average. Since the Industrial Average represents the manufacturing segment of the American economy and the Transports represent the sales and shipping segment of the economy, it is clear that there will be trouble if manufacturers keep making goods but those goods are not going to be sold and shipped in sufficient quantity. This is the simple but fundamental explanation of the current type of non-confirmation (i.e., Transports not confirming Industrials).



The classic "double non-confirmation". At A the two Averages rise to peaks. During B both Averages decline. During C Average 1 goes to a new recovery high, but Average 2 fails to confirm. During D another decline occurs. During E Average 2, which had been the weaker Average during A, B, C, and D, pushes above the peak formed in the C area. Average 1, which was stronger all during A, B, C, and D, now fails to confirm. Thus, first Average 2, then Average 1 shows evidence of weakness. During F both Averages move strongly into a reversal.

Now we come to what I term the "double non-confirmation". The double non-confirmation is usually a very powerful reversal signal in the Averages. In fact, when it is completed I would say it is the most powerful reversal signal which I have seen given by the market.



Here is how the double non-confirmation works (see chart, page 2). First one Average fails to confirm the other and a decline ensues. Following the decline, a new rally begins and on the new rally another non-confirmation takes place. But this time it is the previously strong Average which is weak, in that the previously strong Average refuses to confirm a peak on the weaker Average.

Perhaps this will be clearer if I apply it to the present. Since June 3, the Industrial Average has obviously been the stronger Average, since it has rallied to new recovery highs while Transports have failed persistently to better their June 3 peak. On September 8 the Industrials touched a new recovery peak of 773.14. A little decline followed, and on the next rally the Transports (the weaker Average) pushed above its September 8 peak. So far, Industrials have refused to confirm in that they have not bettered their own September 8 peak.

Therefore, we can say that since June 3 the Transports have been consistently weak since they have never bettered their June 3 high. Next we can say that since September 8 the Industrials have been weak since Transports have pushed above the September 8 high, and this time it is the Industrials which have not confirmed.

Now, obviously if in the next week or so Industrials do rally above 773.14, the potential double non-confirmation will be erased. However, if Industrials fail to better 773.14 and a decline begins, this decline could be the beginning of something very serious, since the decline would have been 'signaled' by a double non-confirmation in the Averages (in which first Transports proved weak, and later Industrials proved weak).

In the hopes of clarifying this whole study, I have included two charts. The first is a chart showing the "double non-confirmation" in "idealized" form, using two theoretical Averages. The second chart traces the current movement in the Averages, and is a reproduction of the page 1 chart. I have marked off the areas A, B, C, D, and E on the current plot of the Averages so that they correspond to the A, B, C, D, and E of the theoretical chart. Many people can understand a theory, but not too many can apply a theory to real life. In other words, what I have done here is to show the double non-confirmation in theoretical form and then applied it to the current market.

We will undoubtedly have many chances to study double non-confirmations again, since they occur perhaps once or twice each year. They may occur at the top of a rally (signifying great weakness) or at the bottom of a decline (signaling great strength). Obviously, I always accord a double non-confirmation the greatest significance when it signals a potential movement in the primary direction as it may now be doing.

THOUGHTS ON THE LONG TERM: In a later section of this Letter, I include a chart showing the yield relationship between the broad D-J 40-Bond Index and the D-J Industrial Average. What this chart tells me is that the underlying fundamentals of the U.S. securities markets have been deteriorating even while the bear market is moving into its fifth year. Sooner or later during this bear market there is going to be an adjustment which will be violent enough, or extended enough, to reverse the yield chart and bring bonds back into their "normal" relationship with stocks. That means bonds will provide greater average yields than common stocks.

Actually, as I study that bond-stock yield chart I get a frustrated and frightened feeling regarding the long-term picture. For the adjustment which is called for is going to be very severe, and I am beginning to wonder how it can be accomplished even

within a year or so. Of course it is possible that a great collapse in stocks, followed by a drastic recession and a build-up in corporate liquidity (and a huge drop off in money requirements) could serve to bring the stock-bond yield situation back to normal. This could conceivably take place within the next year or so or perhaps by 1972. Then again, the adjustment in the securities markets could be long, extended and tortuous. Personally, I would rather have the first type of adjustment than the second.

The reason why the bond-stock yield chart looks the way it does is that our Government, through its massive and unrelenting policy of manipulating the economy, will not allow a real adjustment to take place. People do not realize it, but everytime the Government passes some new welfare legislation, everytime the Government comes out with a new plan to "guarantee" prosperity, it is interfering with the natural forces of supply and demand. The Government is, in effect, demanding that the economy go up and up with never a major correction. To my mind (and I am certainly in favor of a certain amount of sane welfare laws) the ultimate outcome of these policies can be compared with shooting a good race horse full of bigger and bigger doses of adrenalin. The horse, through artificial stimulation, may break records for a certain amount of time, but sooner or later he's going to get heart failure and drop dead. Artificial stimulation has its place in medicine, but you can use it to excess. And excess describes our Government's economic policies ever since World War II.

The first heart attack in the stock market occurred during 1966. The second occurred during 1969-70. The second was much worse than the first, but the patient would not take heed and stay off stimulants. I believe there is another attack coming, and it could well be the most drastic of all. The more stimulation now, the more speculative response from Wall Street to that stimulation, the worse the third attack is going to be.

My friend Irving Weiss (who was recently written up in the authoritative Weekly Bond Buyer as one of the few men who has been calling the shots in the money market) sent me a report last week which throws much light on the plight of the bond market. If Weiss is right, the stage is being set for the next major downward leg in the securities market. Weiss notes that only a few years back both public and private offerings of bonds averaged less than $1.5 billion a month. This year the offerings have pushed up to a whopping $2.5 billion per month.

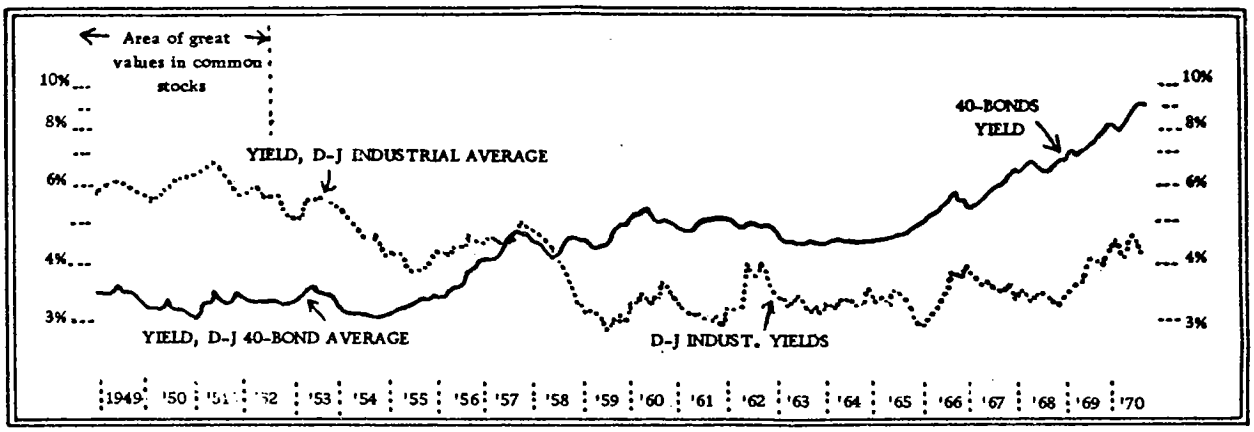
That $2.5 billion, states Weiss, is just the beginning. Weiss has studied 100 leading corporations who are trying desperately to get more liquid. Weiss estimates that these 100 corporations will need around $30 billion in new debt money during the next six months or about $5 billion per month! Then Weiss notes that local and state governments would like to get about $1 billion a month "just to stay even on their borrowings". On top of this, the mortgage market is trying to obtain about $2 billion monthly, about half of this through various government agencies. Evidence is piling up, says Weiss, that the Federal Government will be trying to get $1 billion or more monthly during the next six months.

Taking all this together, Weiss believes we could get a "phenomenonal demand for funds averaging in the area of $9 billion a month for debt offerings". Now if anything like this occurs, I will make the simple statement that the bond market will crack like an eggshell, taking everything else in the securities markets with it.

YIELDS: One of the critical factors in appraising the market and one which few people understand is that of stock and bond yields. I have drawn a chart which shows the yields on the D-J 40-Bond Average and the D-J Industrials Average from 1949 to date. As stated repeatedly in these Letters, both bull markets and bear markets undergo three fairly distinct psychological phases. One of the characteristics of the third and final phase of a bear market is that common stocks decline to "bargain" levels, with good blue-chips frequently bringing yields of 6% and more.

As seen on the page 5 chart, the 1949-1950 area, when the great 1949-66 bull market began, was characterized by great values in the Dow stocks. All during 1949, 1950 and most of 1951 the 30 Dow stocks could have been purchased to bring average yields of 6% to 7% and better. The money markets were "easy", as exemplified by the fact that the yield on the 40-Bond Average was in the 3% to 3.5% level. In other words, stocks were yielding twice what bonds were yielding.

The stock-over-bond yield situation continued until late-1958. At that time, the yields on bonds surpassed those of stocks, and this relationship has continued ever since. Significantly, it was in 1958 that the 1949-66 bull market went into its spectacular third and final phase. The inverse stock-bond yield relationship continued to widen, and by February, 1966, the 40-Bond Average was yielding 5.00% and the Dow was yielding 2.88%, an inverse spread of 2.12% in favor of bonds. At that point the primary bear market began.



The Dow tumbled to the October, 1966 low of 744.32, then a remarkable and speculative correction took place. By December 3, 1968, the Dow had recovered to 985.21. During that week the yield on the 40-Bonds was 6.74%, the yield on the Dow was 3.24%, and the inverse or negative yield spread was 3.50%, actually greater than the 2.12% negative spread of February, 1966.

From this point the market went into the worst bear market collapse since 1937. Incredibly, however, the collapse produced no great improvement in the negative yield spread. The bond market was in a simultaneous collapse of its own, and the May 26 figures (the recent bottom for the stock market) are interesting. On that week the Dow 40-Bond yield was 8.47% while the yield on the Dow was 4.60%. The negative spread was 3.87% in favor of bonds, actually a worse spread than had existed at either the February, 1966 market high or the December, 1968 high.

Nevertheless, a bear market rally took place, and by last week the Dow was in the 750-60 area at which point the average yield on the Dow was 4.24%. At the same time the yield on the 40-Bonds last week was 9.01%, and this provided one of the worst negative stock-bond yield spreads on record, a spread of 4.77% in favor of bonds.

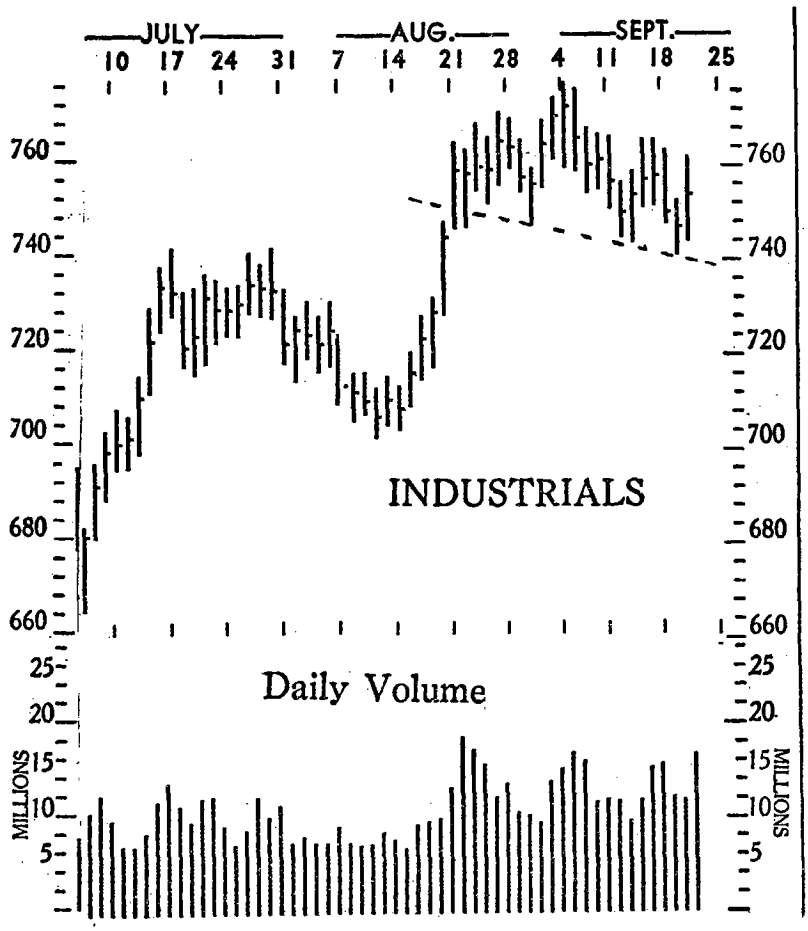
To my mind, this all suggests one thing. This bear market is nowhere near finished, nothing has been corrected, the yield relationship between stocks and bonds is further "out-of-whack" than ever before. The fact is that monetary pressures are still acting adversely on the bond market, and bonds are still in a state of collapse with their yields near record highs. This situation will not change until a state of liquidity has returned and until deficits throughout the nation have reversed their trend. At the same time, common stocks are still reflecting investors' fears of inflation, and yields on the Dow will not come down to bargain levels until inflation fears have changed to deflation fears.

I expect the stock-bond yield relationship to reverse when this bear market goes into its third or final phase. At that time it would not surprise me to see a 2% to 3% yield spread to appear in favor of bonds. Sounds impossible, doesn't it? Perhaps, but I think it's going to happen.

HEAD-AND-SHOULDERS: Following my discussion of the double non-confirmation, I thought it particularly interesting that the recent non-confirmation on the part of the Industrial Average occurred in the form of a "head-and-shoulders" pattern in that Average. I have shown the structure (page 6) which has been forming since late-August, as it appears in the Wall Street Journal. During the development of a H & S pattern, it is usual (if the pattern is to be valid) that volume drop off on each successive rally. As seen on the chart, volume was greatest during the late-August rise (the left shoulder), it receded slightly at the early-September rise (the head), and volume receded still further on the most recent mid-September advance (right shoulder). The support level or "neckline" of this H & S formation comes at about 740. Therefore, I would look for trouble on any close by the Dow below the 740 level.

When a H & S formation appears, it is almost always a sign of distribution. Occasionally, the price movement will reverse and carry above the limits of the head again, but even so the very existence of a H & S pattern implies that distribution has taken place, and the H & S formation should therefore always be considered as a "technical warning".

LATE NOTES: Since the last section was written, it appears that the Jordan-Syrian conflict may be ending, and perhaps in celebration of that happy turn of events the Dow has closed up 10 points for the day (this is written after the close, Wednesday, September 23). This immediately sets up thoughts of a new recovery high for the Dow and a wiping out of the double non-confirmation previously described. Such an event may indeed occur, and if it does I again warn that the situation still appears tenuous and rather dangerous to me.



As noted in the last Letter, volume continues to expand on the upside and decline on any decrease in prices. I do not interpret this phenomenon in the usually accepted way, but feel that it protrays emotional buying and cool-headed selling. Ultimately, the cooler heads are going to win — with a vengeance.

DOW 65: Dow Jones runs a very excellent composite Average which isknown as the D-J 65-Stock Average. This is made up of 30 Industrial stocks, 20 Transportation stocks and 15 Utility stocks. I often study this Average as it provides one with a good "feel" for the overall market. The accompanying chart is arithmetic and is published by M.C. Horsey, Salisbury, Maryland 21801.

The chart covers the whole period of the 1949-66 bull market plus the bear market of 1966 to date. As one studies this chart it is obvious that the bear market has done alot of damage and that it is major in scope. Now I am going to ask readers to draw two trendlines. First draw a trendline connecting the 1949 bull market bottom and the 1966 bull market top. Then draw a second trendline connecting the 1966 bull market top with the 1970 low. These two trendlines will show you the bull market rate of ascent and the bear market rate of descent.

What strikes me is that the bear market rate of descent has actually been rather shallow so far — not much steeper than the bull market rate of ascent. This is unusual and atypical. I would guess that before this bear market is over, the trendline from the 1966 top to the bear market bottom will be much steeper. Of course, the only thing which will make it steeper will be another deep-down low established in the next year or so. It's just a thought, but one that applies to most bull markets and ensuing bear markets.